

## Internal Revenue Service

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Washington, DC 20224

Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01

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Date: June 13, 2006

### Legend:

X =

State =

D1 =

D2 =

D3 =

Y =

Trust 1 =

Trust 2 =

D4 =

Trust 3 =

D5 =

Dear :

This responds to the letter dated January 30, 2006, and related correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code ("Code") for an inadvertent termination of S election.

### **FACTS**

The information submitted states that X was incorporated under the laws of State on D1, and elected to be treated as an S corporation effective D2. On D3, a portion of the stock of X was transferred to Y, a partnership and an ineligible shareholder. Y had two trust partners: Trust 1 and Trust 2, both also ineligible shareholders. On D4, a portion of the stock of X was transferred to Trust 3, a grantor trust.

X and its shareholders represent that they were unaware of the fact that Y is an ineligible shareholder and did not intend the S election of X to terminate. Immediately after they discovered the termination, they took remedial action to rectify the error. Y effected transfers of all of its stock of X to Trust 1 and Trust 2 equally, effective D5. Further, elections on behalf of Trust 1 and Trust 2 were made to be treated as electing small business trusts (ESBTs), effective D5.

### **LAW AND ANALYSIS**

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1)(B) provides that a small business corporation cannot have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1362(d)(2)(A) provides that an election under §1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation.

Section 1361(c)(2)(A)(i) provides that a trust, all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States, may be an S corporation shareholder.

Section 1361(c)(2)(A)(v) states that an ESBT is a permissible shareholder of an S corporation.

Section 1361(e)(1) defines an ESBT, in part, as a trust if—

- (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary,
- (ii) no interest in such trust was acquired by purchase, and
- (iii) an election under this subsection applies to such trust.

Section 1361(e)(3) provides that an election to be an ESBT shall be made by the trustee. Any such election shall be applied to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consent, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken - (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely upon the representations made and the information submitted, we conclude that X's S election terminated on D3, when a portion of the stock of X was transferred to Y. We further conclude, however, that the termination was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after D3, unless X's S election is otherwise terminated under § 1362(d), provided that Y, Trust 1, and Trust 2 make any adjustments that are necessary to comply with this ruling.

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, copies of this letter ruling will be sent to your authorized representatives.

Sincerely,

David R. Haglund  
Senior Technician Reviewer  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter  
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cc: